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Shock waves from Zurich

HENRY ERGAS THE AUSTRALIAN JANUARY 19, 2015 12:00AM

Nominal interest rates (10-yr bond rate) 2007-2014



LAST Thursday, in a dramatic policy reversal, the Swiss National Bank abandoned the cap it had maintained since 2011 on the value of Switzerland's currency. The move, which took markets by surprise, saw the currency rocket from 1.20 to 0.85 Swiss francs per euro, before settling just above parity. But while that 23 per cent appreciation may have stabilised the Swiss franc, the shock waves will reverberate for months to come.

It's not that the direct impacts are that great: despite its importance as a financial centre, Switzerland, with a population of only eight million, accounts for less than 0.5 per cent of world output. But the news highlights the fault lines on which the world economy is poised.

The pressure points are obvious: the continuing crisis in the eurozone; the likelihood China will undershoot its growth target; the deteriorating outlook for emerging economies and oil-exporting countries; the uncertain prospects of "Abenomics"; and on top of all that, the fear of deflation.

Yes, the US is enjoying a solid, if unspectacular, recovery; and yes, lower oil prices will boost consumer demand in the oil-importing countries. But set against the headwinds, those seem a weak reed on which to pin the world's hopes.

There is, however, a deeper malaise as well. After all, if capitalism has been such a spectacular success, it is because it rewards investors and entrepreneurs for anticipating the needs of consumers, not the whims of governments. Yet the global financial crisis thrust governments back to centre stage: and so far, there is no sign of that reversing.

Sure, stimulus packages were an element in the return of the state, as were bank bailouts and recapitalisations. But while their scale was exceptional, those measures were hardly unprecedented.

What was unprecedented, and has proven more enduring, was the role accorded to central banks. As that role has grown, so has the extent to which the world economy is shaped less by fundamentals than by cravings for monetary sugar hits, the fear of those sugar hits being withdrawn, and the scramble for safe assets such as Swiss francs and German bonds, driving their prices to historic highs and the interest rates on them to historic lows.

In part, the change simply reflects the period leading up to the GFC and then the GFC itself. The “great moderation”, which combined low inflation and sustained growth, saw an enormous expansion in the financial sector, fuelled by the development of ever more complex financial instruments.

The Bank for International Settlements, for example, estimates that from June 1998 to December 2008, the market value of traded derivatives increased from \$US2.6 trillion to \$US35.3 trillion, equivalent to about half of global output. That was paralleled by the growth of a “shadow banking sector”, whose US assets nearly equalled American GDP when the GFC broke.

Described by the US Financial Crisis Inquiry Commission as “opaque and laden with short-term debt”, that shadow banking sector imploded once the music stopped. As they tried to limit the fallout, central banks intervened to support a far broader set of instruments and institutions than traditionally came within their ambit.

But that proved merely a way-station to a wide range of unconventional forms of intervention. The most important has been “quantitative easing”, in which central banks purchase financial assets to shift investors’ portfolios from bonds to higher-risk instruments such as equities. As QE was implemented, central bank asset holdings swelled, with the US Federal Reserve’s balance sheet rising 3½ times between 2007 and mid-2012.

Whether QE “worked” will be debated for years to come. What is certain is that it is not going away. While the Fed has stopped its asset purchase program, the Bank of Japan has embarked on one which, relative to the size of the respective economies, is four times larger than the Fed’s at its peak. And the European Central Bank is expected to announce a new, far-reaching, round of QE this Thursday.

The sheer scale of those interventions means central banks don’t merely set the stage: they write the script, act in the play and revise the rules as the plot unfolds. True, they have always done that to some extent; but the change in degree is so great as to be a change in kind.

One consequence of that change is inherent in government intervention: it concentrates risk, making outcomes dependent on actors whose behaviour is always difficult to predict — as the Swiss National Bank’s sudden policy reversal, forced upon it by the ECB’s intention to depreciate the euro, made all too clear.

But the consequences go far deeper than that. The distinction between monetary and fiscal policy has always been blurred; QE eliminated it entirely.

When the ECB tries, for example, to stimulate lending to small business, it cannot avoid acting as a government does in dispensing subsidies, not least in deciding what is a small business and what isn’t. Yet along with other independent central banks, it is subject to none of the checks and balances parliaments impose on the use of taxpayers’ funds.

Whether that is politically sustainable remains to be seen. So does whether it is desirable: at the moment, central banks, whatever their defects, look pretty good compared to voters' elected representatives.

But they are neither omniscient nor omnipotent; and with even the gnomes of Zurich buckling, last week's developments should focus our attention on just how treacherous the waters are that the Australian economy must navigate.

This is a new world, but not a benign one. As parliament gets ready to resume, we are no better equipped to handle that fact than we were a year ago.

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